DEPARTMENT OF STATE REVENUE

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Letter of Findings Number: 06-0027
Income Tax
For Tax Years 2002-03

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ISSUE

I. Gross Income Tax–Imposition

Authority: Enterprise Leasing Co. of Chicago v. Indiana Department of State Revenue, 779 N.E.2d 1284 (Ind. Tax 2002); 45 IAC 1.1-2-1; 45 IAC 1.1-2-5

Taxpayer protests the imposition of gross income tax for the years in question.

II. Adjusted Gross Income Tax–Imposition

Authority: IC 6-3-2-2; 45 IAC 3.1-1-8; 45 IAC 3.1-1-38; 45 IAC 3.1-1-55

Taxpayer protests the imposition of adjusted gross income tax for the years in question.

III. Tax Administration–Negligence Penalty

Authority: IC 6-8.1-10-2.1; 45 IAC 15-11-2

Taxpayer protests the imposition of a ten percent negligence penalty.

STATEMENT OF FACTS

Taxpayer is a California domiciled company which arranges temporary medical services for customers throughout the country, including Indiana. Until 2001, taxpayer had employed the temporary medical employees. Starting in 2002, taxpayer contracted with a subsidiary which employed the temporary medical employees. As the result of an audit, the Indiana Department of Revenue ("Department") issued proposed assessments for corporate income tax for the years 2002 and 2003. Taxpayer protests the imposition of these assessments. Further facts will be supplied as required.

I. Gross Income Tax–Nexus

DISCUSSION

Taxpayer protests the imposition of gross income tax. Taxpayer would be contacted by potential clients in need of temporary medical personnel. Taxpayer would then arrange for another (third) company to provide the temporary medical personnel to taxpayer's customer. The third company pays Indiana income taxes. The Department issued proposed assessments on the basis that taxpayer was providing services in Indiana via a subcontractor. The Department imposed gross income tax and referred to 45 IAC 1.1-2-1, which states:

(a) Except as otherwise provided in this article or IC 6-2.1, the gross income tax is imposed upon the receipt of:

(1) the entire gross income of a taxpayer who is a resident or a domiciliary of Indiana; and

(2) the gross income derived from an activity, a business, or another source within Indiana by a taxpayer who is not a resident or a domiciliary of Indiana.

(b) A taxpayer described in subsection (a)(2) who has contracted with a commercial printer for printing shall not have taxable gross income from:

(1) the ownership or leasing by that entity of tangible or intangible property located at the Indiana premises of the commercial printer;

(2) the sale by that entity of property of any kind produced at and shipped or distributed from the Indiana premises of the commercial printer;

(3) the activities of any kind performed by or on behalf of that entity at the Indiana premises of the commercial printer; and

(4) the activities of any kind performed by the commercial printer in Indiana for or on behalf of that entity;

if the taxpayer does not operate a fixed place of business in Indiana. In no event shall the taxpayer be considered to have a fixed place of business in Indiana at either the commercial printer's premises or at any place where the commercial printer performs services on behalf of the taxpayer.

Since the income at issue arises solely from the provision of services, a more relevant regulation is 45 IAC 1.1-2-5, which explains the application of gross income tax to "Services" as:

(a) Gross income derived from the provision of a service of any character within Indiana is subject to the gross income tax. This is true even when a service contract calls for the furnishing of tangible personal property in the performance of the contract. The property is used in Indiana in furtherance of the contract and is not exempt under IC 6-2.1-3-3. The property is intrinsically related to and inherently part of the services to be performed. In other words, the property is essential to and inseparable from the performance of the contract.

(b) Except as otherwise provided in this rule and IC 6-2.1-2-4, gross income derived from the provision of

services of any character within Indiana is taxable at the high rate of tax.

(c) Charges for services rendered before delivery of a product such as charges for:

(1) preparation;
(2) fabrication;
(3) alteration;
(4) modification;
(5) finishing;
(6) completion; or
(7) delivery;

are considered a part of the sales price and taxed at the same rate as the gross income from the sale. As used in this subsection, "delivery" means the bringing of the property to a place agreed on by the parties to the contract. For example, delivery is complete when the property is brought to the job site under a construction contract.

(d) Gross income derived from the provision of a service within Indiana, with or without the incidental furnishing of tangible personal property, on goods belonging to another is subject to the gross income tax even though such property is moved in interstate commerce before or after the performance of the service.

(e) When a contract provides for the provision of services in a state besides Indiana, gross income derived from the provision of services within Indiana will be determined by multiplying the gross income derived from the contract by the ratio of Indiana activities to total activities provided under the contract. The activities used will be only those related to the services performed and reasonably calculated to effectuate an equitable allocation and apportionment of the taxpayer's gross income under the contract. However, if the percentage of Indiana activities to total activities under the contract is less than five percent (5%), then the entire proceeds of the contract received in that year are exempt from the gross income tax.

(f) The following are examples of services being performed within Indiana:

(1) The sale of advertising time or space by Indiana publishers and broadcasters, even though the buyer is a nonresident, and even though the publication is disseminated in interstate commerce.

(2) The sale of telecommunications, including telephone, telegraph, and noncable television, if the telecommunications originate or terminate in Indiana and are charged to an Indiana address, and the charges are not taxable under the laws of another state.

(3) The provision of cable television services in Indiana regardless of where the television transmissions originate or are received.

(4) The leasing of motion picture films and intangible telecast rights to exhibitors within Indiana.

(5) The operation of radio and television stations within Indiana, including the sale of advertising time to local and national sponsors and the broadcast of local or national programs.

(6) The leasing of tangible personal property delivered to a site in Indiana where the lessor is directly engaged in locating the property in Indiana, and the leasing of tangible personal property delivered to a site outside Indiana where the lessor is not directly engaged in locating the property outside Indiana. The department will look to the totality of the lessor's activities related to the lease formation and execution and the activities related to the purpose of the lease, the use and possession of the leased property, in determining whether the lessor is directly engaged in locating the property in or outside of Indiana. More than a minimal amount of these activities must be conducted in Indiana. For instance, the activity of delivering property to a common carrier in one (1) state for shipment to another state, in and of itself, will not cause the lessor to be directly engaged in locating the property in or outside of Indiana. Also, the manufacture or ownership of property leased to an Indiana lessee, in and of itself, will not cause the lessor to be directly involved in locating the property in Indiana.

The Indiana Tax Court explained how to determine if income is subject to gross income tax if the taxpayer is not an Indiana domiciliary. In Enterprise Leasing Co. of Chicago v. Indiana Department of State Revenue, 779 N.E.2d 1284 (Ind. Tax 2002), the court explained:

To determine whether gross income is derived from an Indiana "source," the Court must (1) isolate the transaction giving rise to the income ("the critical transaction"), (2) determine whether the Petitioners have a physical presence in, or significant business activities within the taxing state ("business situs"), and (3) determine whether the Indiana activities are related to the critical transaction and are more than minimal, not remote or incidental to the total transaction ("tax situs"). Id., at 1290.

To isolate the "critical transaction" in Enterprise Leasing, the court noted that the out-of-state taxpayer owned vehicles which it leased to an Indiana lessee. The lessee would then control where the vehicles were located within Indiana. The court explained:

Once the lessees made those decisions, the Petitioners merely issued "ship-to" instructions *from their out-of-state headquarters*, at the request of the lessees, to facilitate delivery. The "ship- to" instructions do not rise to the level of "active participation" in the "ownership, leasing, or rental" of property in Indiana. (emphasis in original)

The court further explained:

The evidence shows that the Petitioners' lessees handle the registering and licensing of the vehicles in Indiana. Indeed, only in those instances where a lessee chose not to handle those administrative matters did the Petitioners, *from their out-of-state corporate headquarter*s, mail title applications and/or vehicle registrations to the Indiana Bureau of Motor Vehicles for processing. Such administrative activities do not rise to the level of "active participation" in the "ownership, leasing, or rental" of property in Indiana. Thus, the Petitioners' did not have an Indiana business situs for the years at issue.
(emphasis in original)

Similarly, in the instant case, taxpayer is an out-of-state corporation that takes orders for the provision of services in Indiana, but does not perform those services directly. Rather, taxpayer contracts with a third party to provide those services to taxpayer's customer. Such an arrangement could subject a taxpayer to gross income tax if that taxpayer had sufficient contact with Indiana. In this case, however, taxpayer has provided adequate documentation to establish that it does not have sufficient contact with Indiana to subject itself to gross income tax. Taxpayer has no "business situs" in Indiana, therefore the "critical transaction" did not take place in Indiana as required by Enterprise Leasing.

FINDING

Taxpayer's protest is sustained.

II. Adjusted Gross Income Tax--Nexus

DISCUSSION

Taxpayer protests the imposition of adjusted gross income tax. The Department imposed adjusted gross income tax and referred to 45 IAC 3.1-1-8, which states:

"Adjusted Gross Income" with respect to corporate taxpayers is "taxable income" as defined in Internal Revenue Code–section 63 with three adjustments:

(1) Subtract income exempt from tax under the Constitution and Statutes of the United States. [See Regulation 6-3-1-3.5(a)(050)(a) *[45 IAC 3.1-1-5(a)]*.]

(2) Add back deductions taken pursuant to Interanl *[sic.]* Revenue Code-section 170 (Charitable contributions);

(3) Add back deductions taken pursuant to Internal Revenue Code-section 63 for:

(a) Taxes based on or measured by income and levied at the state level. For purposes of this subsection, the Indiana Gross Income Tax is a state tax measured by income and must be added back (see Miles v. Department of Treasury, 209 Ind. 172 (1935));

(b) Property taxes levied by a political subdivision of any state; and

(c) Indiana motor vehicle excise taxes, except for that portion of the tax not considered an ad valorem tax.

The Department also referred to 45 IAC 3.1-1-38(4), which states:

For apportionment purposes, a taxpayer is "doing business" in a state if it operates a business enterprise or activity in such state including, but not limited to:

(1) Maintenance of an office or other place of business in the state

(2) Maintenance of an inventory of merchandise or material for sale distribution, or manufacture, or consigned goods

(3) Sale or distribution of merchandise to customers in the state directly from company-owned or operated vehicles where title to the goods passes at the time of sale or distribution

(4) Rendering services to customers in the state

(5) Ownership, rental or operation of a business or of property (real or personal) in the state

(6) Acceptance of orders in the state

(7) Any other act in such state which exceeds the mere solicitation of orders so as to give the state nexus under P.L.86-272 to tax its net income.

As stated in Regulation 6-3-2-2(b)(010) *[45 IAC 3.1-1-37]*, corporations doing business in Indiana as well as other states are subject to the allocation and apportionment provisions of IC 6-3-2-2(b)-(n).
(emphasis added)

Of more relevance is 45 IAC 3.1-1-55, which states in part:

When Sales Other Than Sales of Tangible Personal Property Are in This State. Gross receipts from transactions other than sales of tangible personal property shall be included in the numerator of the sales factor if the income-producing activity which gave rise to the receipts is performed wholly within this state. Except as provided below if the income producing activity is performed within and without this state such receipts are attributed to this state if the greater proportion of the income producing activity is performed here, based on costs of performance.

The term "income producing activity" means the act or acts directly engaged in by the taxpayer for the ultimate purpose of obtaining gains or profit. Such activity does not include activities performed on behalf of the taxpayer, such as those conducted on its behalf by an independent contractor. Accordingly, "income producing activity" includes but is not limited to the following: (1) The rendering of personal services by employees or the utilization of tangible and intangible property by the taxpayer in performing a service. (2) The sale, rental, leasing, or licensing the use of or other use of tangible personal property. (3) The sale,

licensing the use of or other use of intangible personal property.

. . .

(emphasis added)

Indiana adjusted gross income tax for non-residents is determined under an apportionment system, as provided in IC 6-3-2-2(b). The apportionment factor is determined by adding the payroll factor plus the property factor plus the sales factor and dividing that number by three. Both the Department and taxpayer agree that taxpayer had no payroll or property to factor in. Since 45 IAC 3.1-1-55 plainly states that income producing activity does not include activities performed on behalf of the taxpayer such as those conducted on its behalf by an independent contractor, as is the case here, there are no sales to factor in either. Therefore, the apportionment factor is zero under IC 6-3-2-2.

FINDING

Taxpayer's protest is sustained.

III. Tax Administration–Negligence Penalty

DISCUSSION

The Department issued proposed assessments and the ten percent negligence penalty for the tax year in question. Taxpayer protests the imposition of penalty. The Department refers to IC 6-8.1-10-2.1(a), which states in relevant part:

If a person:

. . .

(3) incurs, upon examination by the department, a deficiency that is due to negligence;

. . .

the person is subject to a penalty.

The Department refers to 45 IAC 15-11-2(b), which states:

Negligence, on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

45 IAC 15-11-2(c) provides in pertinent part:

The department shall waive the negligence penalty imposed under IC 6-8.1-10-1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section.

In this case, taxpayer did not incur a deficiency due to negligence under 45 IAC 15-11-2(b). Taxpayer has affirmatively established that there was no failure to pay a deficiency, as required by 45 IAC 15-11-2(c).

FINDING

Taxpayer's protest is sustained.

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